A State Earned Income Tax Credit for Kentucky

Dr. James P. Ziliak
Center for Poverty Research
and
Department of Economics
University of Kentucky

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Tax Reform

- Tax system needs to be made consistent with 21st Century economy to provide a more stable funding stream, to encourage work and saving, and to be more distributionally fair
- Low-income workers and families can benefit from fundamental tax reform in Kentucky
- My focus is on State Earned Income Tax Credits

The Economic Case for the EITC

- ***Efficiency:*** Most taxes impose efficiency costs on workers, firms, and consumers
- ***Fairness/Equity:*** The public generally cares about how income is distributed across society
- Recent research on optimal tax theory frequently points to the inclusion of an EITC as part of comprehensive tax reform for both efficiency and equity reasons

The Federal EITC

- Established as a refundable tax credit in 1975
- Only available to low-income workers who file a return
- Currently the $49 billion spent on the EITC lifts 4 million families out of poverty each year
- Expanded generosity in the 1990s played a big role in raising work among single mothers and lowering family poverty.

The Federal EITC

- The Federal EITC has 3 ranges: the “subsidy” range, the “stationary” range, and the “phase out range”
- For Tax Year 2009 the maximum credit for a filer
  - with 0 qualifying children is $457
  - with 1 qualifying child is $3,043
  - with 2 qualifying children is $5,028
  - with 3 or more qualifying children is $5,657

A State EITC

- Presently 23 states plus DC supplement the federal EITC with a state EITC.
- If Kentucky adopts an EITC, how many workers are likely to be affected? How should it be designed? How much will it cost and how should it be financed?
- Much of my analysis draws from the 2007 UKCPR policy brief “A State Earned Income Tax Credit: Issues and Options for Kentucky”
  - http://www.ukcpr.org/PolicyBriefs.aspx

A State EITC

- The Center on Budget and Policy Priorities estimates that the federal EITC injected $735 million into Kentucky’s economy in tax year 2007
- 62% of poor families in Kentucky contain at least one worker, and we estimate that a state EITC could assist over 360,000 working poor in these Kentucky families.
- This is likely a lower bound estimate because the Federal EITC reaches up to twice the poverty line for a 4-person family

A State EITC

- Key Design Issues:

- Refundable vs Non-Refundable
- The Credit Rate
- The Target Population
- Family Size Adjustments
- Advanced Credit Option

A State EITC

- Refundable vs Non-Refundable
  - A refundable credit acts as a wage supplement to earnings and, therefore, is more effective in lifting families with below poverty wages out of poverty.
  - 22 of 24 states have refundable state EITCs.
  - Refunds are mostly spent locally, reducing the net cost of the program.

- Recommendation: Make the EITC refundable

A State EITC

- The Credit Rate
  - The credit rate is the percentage of the federal EITC that is credited on the state tax return.
  - The range among states with refundable credits is 3.5% to 43%, with an average credit rate of 15%.

- Recommendation: Set the credit rate initially at 10%, and gradually increase to 15%

A State EITC

- The Target Population
  - The key issue is whether to default to the Federal criteria for the eligible population, which includes childless workers, or restrict it only to families with qualifying children.
  - 21 of 24 states include childless workers
  - Legislation in Congress to expand generosity of credit to childless workers.

- Recommendation: Follow Federal guidelines for eligible population

A State EITC

- Family Size Adjustments
  - The Federal EITC varies for 0, 1, 2, and 3 or more qualifying children.
  - Adjustments take account of the fact that poverty rates are higher in families with more children
  - Most states (22 of 24) do not make family size adjustments for administrative simplicity
- Recommendation: Apply a common credit rate regardless of family size

A State EITC

- Advanced EITC
  - The Federal EITC allows workers to receive the credit lump sum during the tax season, or throughout the year. A reconciliation at tax return time is required for those with the advanced credit
  - 99% of Federal recipients take the credit lump sum.

- Recommendation: Do not make a separate advanced option.

Financing the State EITC

- In 2005 state expenditure on the EITC ranged from $17 million in Vermont to $570 million in New York, or less than 1% of revenue.
- The CBPP estimates that the cost to the state of an EITC in Kentucky would be $73 million in 2010 with a 10% credit rate
- Reference at http://www.cbpp.org/cms/index.cfm?fa=view&id=2992

Financing the State EITC

- 10 states pay for part of the EITC out of TANF funds
  - This is a challenge during the recession when these funds are used for income support for both non-working and working families with children
- Several others have increased sales taxes to pay for the credit
- The ideal is to include it as part of overall tax reform
- Recommendation: Adopt an EITC in 2010 to help alleviate hardship associated with the recession, to stimulate work, and add greater fairness to our tax code

About UKCPR

- Established in 2002 as one of 4 Federally funded poverty research centers in the U.S., the others being located at the Universities of Michigan, Washington, and Wisconsin
- Research is both national in scope, and a thematic emphasis on poverty in the South
- More detail available at http://www.ukcpr.org/